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THE LENDER WITH TWO MORTGAGES ON THE SAME PROPERTY: RISKS AND STRATEGIES

Brian D. Hulse*

Editors' Synopsis: Lenders commonly hold two mortgages on the same property. Unknown to many lenders, if they foreclose one of the two, a court may deem the debts secured by both to have been satisfied. Courts will apply principles of merger, antideficiency statutes, one-form-of-action rules, and unjust enrichment to prevent the lender from recovering on both notes. This Article examines how such problems may arise when the lender forecloses either the senior or junior mortgage, and suggests ways to draft around the problem, or to avoid it through appropriate foreclosure strategies.

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I. INTRODUCTION

Lenders commonly hold two or even more mortgages or deeds of trust¹ on the same property. Such structures can present difficult and little-known problems for the lender in a default and foreclosure situation. The most fundamental of these problems is the risk that if a lender forecloses one of the two mortgages, a court will deem the debt secured by both mortgages to have been satisfied. If the lender does not anticipate these issues when pursuing its remedies, the lender may severely impair its rights.

The case law in this area is inconsistent. In addition to producing unnecessary variations in outcomes from state to state, this inconsistency has made planning in this context unpredictable. This situation is undesirable in the modern world of real estate finance in which lenders and the secondary markets deal with a national lending market. Unnecessary local variations add additional costs to the lending process, and these costs are ultimately passed on to borrowers.

A number of cases have held that the foreclosure of one of the two mortgages extinguishes the debt secured by the other mortgage, even when the foreclosed mortgage did not secure the same debt that was secured by

¹ For ease of reading, unless otherwise indicated, when the term “mortgage” is used in this Article it includes deeds of trust and similar security instruments.

the other mortgage.² These cases have reached this result by a variety of theories, some of which are of questionable merit. Furthermore, courts too often have applied technical legal theories, such as the doctrine of merger, in mechanical ways that do not address the underlying equities of the case.³

This Article explores these problems and some methods to avoid them at both the loan-structuring stage and at the foreclosure stage. This issue has taken on heightened importance in the current environment of greatly increased foreclosures. This Article focuses on issues that arise in relation to mortgages on commercial properties, although much of the discussion also applies to single family residential mortgages.

When a lender with two mortgages on a property forecloses, it can pursue any of several foreclosure strategies, including:

1. Foreclose the senior lien and eliminate the junior lien.
2. Foreclose the junior lien and later foreclose the senior lien.
3. Foreclose the junior lien without later foreclosing the senior lien.
4. Foreclose both mortgages in a single judicial foreclosure action.
5. Negotiate a deed in lieu of foreclosure from the borrower.⁴

After pursuing one of these strategies, the lender may be able to seek a deficiency judgment on the debt secured by the foreclosed mortgage—depending on the particular state’s applicable laws prohibiting or limiting deficiency judgments—or seek a judgment on an unsecured basis for the debt secured by the mortgage that was not foreclosed.⁵

The appropriate strategy depends on the relative amounts secured by the two mortgages, the value of the property, and the laws of the relevant state.⁶ While the problems discussed in this Article can arise in any state and the cases discussed come from all parts of the country, these problems are most acute in states where nonjudicial foreclosures predominate and antideficiency laws are strict.

² See, e.g., *Simon v. Superior Court*, 5 Cal. Rptr. 2d 428 (Cal. Ct. App. 1992); *Centennial Square, Ltd. v. Resolution Trust Co.*, 815 P.2d 1002 (Colo. App. 1991).

³ See *infra* Part III.A.

⁴ For a discussion of these strategies, see *infra* Part VI.B.2.

⁵ See 1 NELSON & WHITMAN, REAL ESTATE FINANCE LAW § 8.1, at 707–08 (5th ed. 2007).

⁶ For a general discussion of foreclosure strategies, see *infra* Part VI.B.1.

II. RISK OF DEBT EXTINGUISHMENT WHEN SENIOR MORTGAGE IS FORECLOSED

A. General Rule

Most cases hold that if the lender forecloses the senior mortgage, that foreclosure will wipe out the junior mortgage as a lien on the property, but it will generally not operate to extinguish the debt secured by the junior mortgage.⁷ Notwithstanding this general rule, in some states—especially those with strict antideficiency laws⁸—situations exist in which courts will hold that such a foreclosure has extinguished the junior debt. The discussion of the law in California, Georgia, and Oregon in the following Parts illustrates some of the exceptions to the general rule.

B. California Law

The court in *Simon v. Superior Court*⁹ applied California's antideficiency law to preclude the lender from obtaining a judgment on the promissory note secured by a junior mortgage after the lender foreclosed its senior mortgage in a nonjudicial trustee's sale. In that case, unlike some other senior lien foreclosure cases, both loans were made at the same time.¹⁰ The court expressed a strong concern that allowing the lender to foreclose the senior mortgage and to recover as an unsecured creditor on the note secured by the junior mortgage would allow the lender to circumvent the state's antideficiency law, which prohibits recovery of a deficiency judgment from the borrower after a nonjudicial trustee's sale.¹¹ The lender could have avoided that result by foreclosing judicially and recovering a deficiency judgment.¹² California courts might take a different approach if the two loans clearly were distinct and made at significantly different times—or

⁷ See, e.g., *First Sec. Bank of Utah, N.A. v. Felger*, 658 F. Supp. 175 (D. Utah 1987); *United Bank of Lakewood Nat'l Ass'n v. One Center Joint Venture*, 773 P.2d 637 (Colo. App. 1989); *Blackwood v. Sakwinski*, 191 N.W. 207 (Mich. 1922); *Urbach v. Monchamp Corp.*, 821 P.2d 1116 (Or. Ct. App. 1991); see also NELSON & WHITMAN, *supra* note 5, § 6.16 (citing additional cases).

⁸ See discussion in Parts II and III.

⁹ 5 Cal. Rptr. 2d 428 (Cal. Ct. App. 1992).

¹⁰ See *id.* at 429.

¹¹ See *id.* at 432, 437–38.

¹² See *id.* at 437.

perhaps even made by different lenders, but later became owned by the same lender—or if there were an intervening lien held by a third party.¹³

In *Union Bank v. Wendland*,¹⁴ the senior mortgage contained a “drag-net” clause providing that all “the debtor’s past, present and future obligations” to the lender would be secured by the senior mortgage.¹⁵ The lender foreclosed the senior mortgage by nonjudicial trustee’s sale. In a two-to-one decision, the court held that the lender could not recover on the debt secured by the junior mortgage after foreclosing the senior mortgage. However, the lead opinion and the concurring opinion reached this conclusion based on different theories. The lead opinion reasoned that because the promissory note secured by the junior mortgage was also secured by the senior mortgage, the antideficiency law dictated that the foreclosure satisfied all obligations secured by the senior mortgage.¹⁶ The lender therefore was prohibited from obtaining a judgment on the note that was also secured by the junior mortgage, even though the value of the property was substantially less than the aggregate secured debt.¹⁷ The lead opinion unfortunately relied on the doctrine of merger, concluding that the junior mortgage had merged into the senior mortgage. The concurring opinion concluded that the antideficiency law should preclude recovery on the junior debt to prevent the lender both from avoiding a right of redemption and obtaining the functional equivalent of a deficiency judgment (rather than obtaining its deficiency judgment in a judicial foreclosure, which would afford the borrower a redemption period).¹⁸

¹³ See *Evans v. California Trailer Court, Inc.*, 33 Cal. Rptr. 2d 646, 652 n.6 (Cal. Ct. App. 1994) (questioning whether *Simon* rule would apply if one party held two deeds of trust on same property but a third-party lien intervened).

¹⁴ 126 Cal. Rptr. 549 (Cal. Ct. App. 1976). The *Union Bank* case is of questionable precedential effect because the decision was split two to one and neither the concurring judge nor the dissenting judge joined the lead opinion. See *Nat’l Enters, Inc. v. Woods*, 115 Cal. Rptr. 2d 37, 44 (Cal. Ct. App. 2001) (noting that concurrence in *Union Bank* explicitly rejected the lead opinion’s analysis, and citing earlier case for proposition that “judgment of an equally divided Supreme Court is without force as precedent”).

¹⁵ *Union Bank*, 126 Cal. Rptr. at 553.

¹⁶ See *id.* (citing CAL. CIV. PROC. CODE § 580d (West 1976 & Supp. 2009) (“No judgment shall be rendered for any deficiency upon a note secured by a . . . mortgage upon real property . . . executed in any case in which the real property . . . therein has been sold by the mortgagee . . . under power of sale contained in such a mortgage . . . ”)).

¹⁷ See *id.* at 558–59.

¹⁸ See *id.* at 561 (Elkington, A.J., concurring).

*National Enterprises, Inc. v. Woods*¹⁹ involved a similar loan structure but reached a different outcome. In that case, a lender made two mortgage loans secured by the same property. The junior loan was made two years after the senior loan for the purpose of paying delinquent amounts owing on the senior loan. By the time of the foreclosure, separate creditors held the two loans. The holder of the senior mortgage judicially foreclosed it. The trial court held that the foreclosure of the senior mortgage operated to extinguish the debt secured by the junior mortgage under the one-form-of-action rule of California Code of Civil Procedure section 726.²⁰ The court of appeals reversed, holding that unless there is evidence that the loans were originally structured to circumvent the one-form-of-action and antideficiency rules, the two mortgages should be not be treated as if they were held by the same creditor merely because they were originally made by the same lender.²¹ The appellate court also distinguished *Simon* on the basis that the senior mortgage in this case was judicially foreclosed, which did not implicate California's antideficiency rules in the way a nonjudicial foreclosure, such as that in *Simon*, does.²²

C. Georgia Law

In the recent case of *Iwan Renovations, Inc. v. North Atlanta National Bank*,²³ the Court of Appeals of Georgia held that a lender's nonjudicial foreclosure of a first lien mortgage precluded it from obtaining a judgment against the borrower on the promissory note secured by a second lien mortgage on the same property, which was not foreclosed.²⁴ The Georgia nonjudicial foreclosure statute provided that a mortgagee may not obtain a deficiency judgment unless it "shall, within 30 days after the [nonjudicial foreclosure] sale, report the sale to the judge of the superior court of the county in which the land is located for confirmation and approval and shall obtain an order of confirmation and approval thereon."²⁵ In *Iwan*, the lender

¹⁹ 115 Cal. Rptr. 2d 37.

²⁰ See *id.* at 40–41 (quoting CAL. CIV. PROC. CODE § 726(a) (West 1976 & Supp. 2009)) ("There can be but one form of action for the recovery of any debt or the enforcement of any right secured by mortgage upon real property or an estate for years therein . . .").

²¹ See *id.* at 46–47.

²² See *id.* at 51–52.

²³ 673 S.E.2d 632 (Ga. Ct. App. 2009).

²⁴ The court did not decide whether the lender could obtain a judgment against the guarantor of the note secured by the second lien mortgage because that issue was not presented on appeal. See *id.* at 636.

²⁵ GA. CODE ANN. § 44-14-161(a) (2002).

foreclosed its senior mortgage nonjudicially, but did not report the sale to the superior court. The lender then sought to obtain a judgment against the borrower and the guarantor of the note secured by its second lien mortgage.

The court of appeals held that the lender could not obtain such a judgment without obtaining the confirmation and approval of the sale under the first lien mortgage. In so holding, it stated: "This Court has applied OCGA § 44-14-161(a) to foreclosure proceedings on separate debts which are *inextricably intertwined* to prevent creditors from circumventing the statute's mandates by making successive loans against the security of the same property."²⁶ The court went on to say that "[a]s a general rule, two debts that are incurred for the same purpose, secured by the same property, held by the same creditor, and owed by the same debtor are inextricably intertwined."²⁷ The court ultimately held that the two notes and mortgages were inextricably intertwined even though the later note and mortgage were executed seven months after the earlier ones because the latter execution was in conjunction with a modification of the earlier ones. The court distinguished earlier Georgia cases that reached a different result where a junior creditor purchased the senior lien debt from a different creditor.²⁸

D. Oregon Law

Other courts could reach results similar to those reached by California and Georgia courts based on the antideficiency and one-form-of-action laws of their jurisdiction. However, at least one court in a state with an antideficiency law applicable to nonjudicial foreclosures has declined to apply reasoning similar to that in the California and Georgia cases discussed above. In *Urbach v. Monchamp Corp.*,²⁹ the Oregon Court of Appeals permitted the lender to obtain a judgment on the promissory note secured by its junior mortgage after conducting a nonjudicial foreclosure under its senior mortgage where both notes and mortgages were entered into simultaneously. Oregon law prohibited a deficiency judgment on an obligation secured by a deed of trust after a nonjudicial foreclosure of that deed of trust.³⁰ However, a dissenting opinion in *Urbach* expressed a concern similar to the one that troubled the *Simon* court:

²⁶ *Iwan*, 673 S.E.2d at 635. (Emphasis added).

²⁷ *Id.*

²⁸ *Id.* at 635-36.

²⁹ 821 P.2d 116 (Or. Ct. App. 1991).

³⁰ See OR. REV. STAT. § 86.770(2) (2007).

[T]he majority's construction of ORS 86.770(2) . . . will permit lenders to avoid that statute's constraints simply by requiring a borrower to execute two notes and two trust deeds. On default, the lender can foreclose one trust deed, recover the security, preclude the borrower from redeeming the property [because the borrower has no redemption rights under Oregon's trust deed act after a nonjudicial foreclosure] and then bring an action on the other note.³¹

An amendment to Oregon's trust deed statute, signed into law on August 4, 2009, has limited somewhat the effect of *Urbach*.³² Section 2 of House Bill 3004 amended section 86.770(2) of the Oregon Revised Statutes, the state's antideficiency law, to provide that where a residential trust deed³³ is foreclosed judicially or nonjudicially, no deficiency or other judgment may be entered on "[a]ny other note, bond or other obligation" where that other obligation is secured by another residential trust deed or mortgage on the same property if (1) the two obligations were "created at the same time" and (2) the other obligation is "owed to the beneficiary in the residential trust deed that was subject to the trustee's sale or the foreclosure."³⁴ That portion of the statute does not address how close in time the two obligations must be in order to be "created at the same time," nor does it clearly address the situation in which one of the obligations has been transferred by the original creditor. Section 3 of House Bill 3004 also adds a new subsection to section 88.070 (which precludes a deficiency judgment in judicial foreclosures of certain purchase money mortgages), providing:

If a purchaser gives more than one mortgage to a seller or a single lender to finance the purchase of real property that the purchaser uses as the purchaser's primary single family residence *and the seller or lender or a subsidiary, affiliate*

³¹ *Urbach*, 821 P.2d at 1118.

³² H.B. 3004, 75th Leg. Assem., Reg. Sess. (Or. 2009).

³³ The term "residential trust deed" is defined in Oregon Revised Statutes section 86.705(3) (2007) to mean "a trust deed on property upon which are situated four or fewer residential units and one of the residential units is occupied as the principal residence of the grantor, the grantor's spouse or the grantor's minor or dependent child at the time a trust deed foreclosure is commenced." Presumably, the Oregon case law on the issues discussed in this article remains effective with respect to mortgages on commercial properties and other mortgages that do not constitute "residential trust deeds" under the statutory definition.

³⁴ Or. H.B. 3004.

*or successor of the seller or lender continues to hold the mortgages at the time of foreclosure, judgment remedies for the collection of unsatisfied amounts that the grantor owes to the seller or lender or the subsidiary, affiliate or successor of the seller or lender on notes secured by the mortgages expire when the real property is sold in accordance with the foreclosures.*³⁵

Because Section 3 of the bill specifically addresses the situation in which the lender has transferred one or both of the mortgages, a lender could possibly avoid the effect of Section 2 by transferring one of the mortgages—perhaps even if that transfer is to an affiliate of the original lender.

E. Unjust Enrichment

Finally, where the value of the property acquired by the lender through foreclosure of the first mortgage exceeds the debt secured by the first mortgage, a court possibly could deny the creditor a judgment on the junior mortgage or limit the amount of such a judgment on the theory that the lender would be unjustly enriched to the extent of the excess value. However, one court has questioned whether such a theory would succeed, at least under Oregon law.³⁶ The unjust enrichment theory is discussed in greater detail in Part III.B, *infra*, in connection with cases in which it has been applied when the junior mortgage is foreclosed.

III. RISK OF DEBT EXTINGUISHMENT WHEN JUNIOR MORTGAGE IS FORECLOSED

When the lender forecloses on the junior mortgage, the situation is unlike that in which the senior mortgage is foreclosed. As a leading treatise notes:

[I]f the holder of both a junior and senior mortgage forecloses the junior and buys at the foreclosure sale it is generally held that, in the absence of an agreement to the contrary, the mortgagor's personal liability for the debt secured by the first mortgage, or for a deficiency, is extinguished.³⁷

³⁵ Or. H.B. 3004 (emphasis added).

³⁶ See *Atl. Nat'l Trust L.L.C. v. Gunderson*, 132 F. Supp. 2d 1284, 1288–89 (D. Or. 2000).

³⁷ 1 NELSON & WHITMAN, *supra* note 5 § 6.16, at 552–53.

Most recent cases applying this general rule date from the real estate recessions of the 1980s and early 1990s.³⁸ These cases rely on leading cases from the 1930s and earlier.³⁹

The cases applying this rule of debt-extinguishment when a junior mortgage is foreclosed have based their results on various theories, including: (1) *merger*—either merger of estates, where the unforeclosed mortgage is deemed merged into the fee title acquired by foreclosure of the other mortgage,⁴⁰ or merger of rights, which is sometimes referred to as the doctrine of extinguishment⁴¹ or the primary fund doctrine;⁴² (2) *unjust enrichment*—where the value of the property exceeds the amount secured by the foreclosed mortgage;⁴³ and (3) a *presumption* that a bidder at a foreclosure sale on a junior mortgage takes the amount of the senior mortgage into account in the amount of the bid and that the property becomes the primary fund for payment of the senior debt.⁴⁴ Courts often use a combination of these theories, expressed in confusing and overlapping terms. Each of the theories is discussed below.

A. Merger

Most of the relevant cases discuss the legal doctrine of merger. The misuse of that doctrine by courts has brought a great deal of confusion to the law in this area.

Mid Kansas Federal Savings and Loan Ass'n of Wichita v. Dynamic Development Corp.,⁴⁵ states the familiar rule of merger of estates:

³⁸ See *Mid Kan. Fed. Sav. & Loan Ass'n of Wichita v. Dynamic Dev. Corp.*, 804 P.2d 1310 (Ariz. 1991); *Centennial Square, Ltd. v. Resolution Trust Co.*, 815 P.2d 1002 (Colo. App. 1991); *Bd. of Trs. of the Gen. Ret. Sys. of Detroit v. Ren-Cen Indoor Tennis & Racquet Club*, 377 N.W.2d 432 (Mich. Ct. App. 1985); *First Bank Nat'l Ass'n v. Northside Mercury Sales & Serv., Inc.*, 458 N.W.2d 424 (Minn. Ct. App. 1990); *Tri-County Bank & Trust Co. v. Watts*, 449 N.W.2d 537 (Neb. 1989); *Licursi v. Sweeney*, 594 A.2d 396 (Vt. 1991).

³⁹ See *Belleville Sav. Bank v. Reis*, 26 N.E. 646 (Ill. 1891); *Sletten v. First Nat'l Bank of Carrington*, 163 N.W. 534 (N.D. 1917); *Wright v. Anderson*, 253 N.W. 484 (S.D. 1934).

⁴⁰ See, e.g., *First Bank Nat'l Ass'n*, 458 N.W.2d at 427; *Mid Kan.*, 804 P.2d at 1317; *Licursi*, 594 A.2d at 400.

⁴¹ See *Mid Kan.*, 804 P.2d at 1318.

⁴² See *Wright*, 253 N.W. at 487–88.

⁴³ See *First Bank Nat'l Ass'n*, 458 N.W. 2d at 428.

⁴⁴ See *Bd. of Trs. of the Gen. Ret. Sys. of Detroit v. Ren-Cen. Indoor Tennis & Racquet Club*, 377 N.W. 2d 432, 434–35 (Mich. Ct. App. 1985).

⁴⁵ 804 P.2d at 1310.

Generally, when one person obtains both a greater and a lesser interest in the same property, and no intermediate interest exists in another person, a merger occurs and the lesser interest is extinguished. . . . The potential for merger arises whenever a mortgagee acquires the mortgagor's equity of redemption. However, even if a merger would otherwise occur at law, contrary intent or equitable considerations may preclude this result under appropriate circumstances.⁴⁶

The court went on to describe another concept, which it referred to as "merger of rights":

The basis of the merger of rights doctrine is that the purchaser at a foreclosure sale of a junior lien takes subject to all senior liens. Although the purchaser does not become personally liable on the senior debt (as does an assuming grantee), the purchaser must pay it to avoid the risk of losing his newly acquired land to foreclosure by the senior lienholder. Therefore, the land becomes the primary fund for the senior debt, and the purchaser is presumed to have deducted the amount of the senior liens from the amount he bids for the land

. . . Of course, this rule comes into play only when the equity of redemption is extinguished. Although the deed of trust is a relatively new instrument that post-dates cases such as *Wright* and *Belleville*, we find the doctrine of merger and extinguishment even more compelling under a modern deed of trust statute, which cuts off the borrower's equity of redemption at the time of the trustee's sale.⁴⁷

Most of the cases do not clearly distinguish the merger of estates theory from the merger of rights theory as the *Mid Kansas* court did. Many discuss the concepts in a muddled way and ultimately come to the conclusion that the lender cannot enforce the debt secured by the senior mortgage after it forecloses the junior mortgage.⁴⁸

⁴⁶ *Id.* at 1317 (citations omitted).

⁴⁷ *Id.* at 1318–19 (citations omitted).

⁴⁸ See, e.g., *Centennial Square, Ltd. v. Resolution Trust Co.*, 815 P.2d 1002, 1005 (Colo. App. 1991); *Bd. of Trs. of the Gen. Ret. Sys Detroit*, 377 N.W.2d at 436; *First Bank*

The Missouri courts take a position contrary to that of most states. Missouri has a strong line of cases refusing to find that the foreclosure of a junior mortgage satisfies the debt secured by a senior mortgage on the same property held by the same lender. The most recent Missouri case on the subject is *Savannah Place, Ltd. v. Heidelberg*.⁴⁹ In that case, the lender foreclosed its junior lien and bought the property for a credit bid of \$100,000—approximately \$14,000 less than the amount secured by the junior mortgage. It then sought a judgment against the guarantors for the amounts left unpaid under both loans. The trial court awarded the lender a judgment of over \$1.6 million. After observing that “merger is one of the most complex and confusing areas of the law of mortgages,”⁵⁰ the court of appeals affirmed the award. In doing so, it declined to follow the *Mid Kansas* case and focused on the “intent of the parties, especially the one in whom the interests unite.”⁵¹ Quoting from two earlier Missouri cases, the *Savannah Place* court stated:

[T]he lien of a mortgage is not merged in the title acquired by the mortgagee, at a sale of the mortgaged premises under a junior mortgage, or judgment, when it is his intention that there shall be no merger; and in the absence of evidence to the contrary, his intention will be presumed to accord with his interests.⁵²

Where the borrower has a redemption right after the foreclosure sale on the junior mortgage, some cases holding that a merger results from the foreclosure have ruled that the merger does not occur until the end of the redemption period.⁵³ Presumably, courts apply this delay in merger so that if the borrower or another party with redemption rights redeems the property and thereby deprives the foreclosing lender of the value of the property in excess of the bid amount, it does so subject to the senior mortgage.

The merger of estates theory is a poor fit for the multiple mortgage situation for two reasons. First, as the above cases acknowledge, merger of estates is generally a question of intent and usually will not be imposed to

Nat'l Ass'n, 458 N.W.2d at 427–28; *Sletten v. First Nat'l Bank of Carrington*, 163 N.W. 534, 537 (N.D. 1917).

⁴⁹ 122 S.W.3d 74 (Mo. Ct. App. 2003).

⁵⁰ *Id.* at 83.

⁵¹ *Id.*

⁵² *Id.* at 84 (quoting *Morgan v. York*, 91 S.W.2d 244, 247–48 (Mo. Ct. App. 1936)).

⁵³ See, e.g., *Belleville Sav. Bank v. Reis*, 26 N.E. 646, 647 (Ill. 1891); *Sletten v. First Nat'l Bank of Carrington*, 163 N.W. 537 (N.D. 1917).

the disadvantage of the party holding the interests to be merged.⁵⁴ Second, the mere merger of the two estates affects only the interest of the party holding the merged estates in the property—properly applied, it does not affect the enforceability of the debt secured by the merged mortgage at all. As one commentator has noted: “Courts’ applications of merger in this context are particularly perplexing because merger, a property title device, is manifestly inapplicable to issues of debt enforceability.”⁵⁵ Interestingly, the early and frequently cited South Dakota case of *Wright v. Anderson*⁵⁶ does distinguish the two theories well.⁵⁷ The *Wright* court stated: “[T]he situation does not (precisely speaking) involve a question of merger at all, though it does involve a doctrine which is in some respects somewhat analogous to merger, and which is sometimes loosely (and confusingly) referred to under that head.”⁵⁸ Despite this early authority, courts have continued to apply merger law in strained ways in the multiple mortgage context.

The *Restatement (Third) of Property (Mortgages)* is harshly critical of the use of the doctrine of merger to resolve mortgage issues. In fact, the *Restatement* would make the doctrine inapplicable to mortgages and the obligations they secure.⁵⁹ It states:

As applied in the mortgage setting, the theory holds that when a mortgagee’s interest and a fee title become owned by the same person, the lesser estate, the mortgage, merges into the greater, the fee, and is extinguished unless the holder intends a contrary result. This extension of the merger principle has created one of the most complex, confusing, and frequently litigated areas of mortgage law. Not only is merger often invoked for the proposition that the mortgage no longer exists, but it is also asserted as a defense to the mortgage obligation itself. This situation is especially unfortunate because the doctrine is simply unnecessary in the modern mortgage law context. In every mortgage context a court will be able to reach a just and

⁵⁴ See, e.g., *Savannah Place*, 122 S.W.3d at 83.

⁵⁵ Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 386 (1987).
⁵⁶ 253 N.W. 484 (S.D. 1934).

⁵⁷ The *Wright* court refers to the concept that the *Mid Kansas* court later called the “merger of rights” theory as the “doctrine of extinguishment,” a term that is much less likely to create confusion. See *id.* at 487.

⁵⁸ *Id.* at 486.

⁵⁹ See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.5 (1997).

equitable result without resort to the vagaries of the merger doctrine. Moreover, ending reliance on merger makes mortgage law more predictable and efficient. Consequently, this section seeks to end mortgage law's misplaced reliance on merger by making it clear that the doctrine is inapplicable both to mortgages and the obligations they secure.⁶⁰

Courts should recognize that merger is not a helpful or even appropriate doctrine in analyzing the effect that foreclosing a junior mortgage has on the debt secured by a senior mortgage on the property held by the same lender.⁶¹

B. Unjust Enrichment

Unjust enrichment is a more appropriate theory with which to resolve these cases. The *Restatement* examines the merger cases and concludes that, despite their use of merger language, the cases ultimately are based on a theory of unjust enrichment.⁶² In its discussion of the *Mid Kansas* case⁶³ and others similar to it, the Reporter's Note to the *Restatement* says:

The primary focus of these decisions is not merger, but the avoidance of unjust enrichment. They emphasize that the mortgagee's purchase subject to its own lien makes the real estate the primary fund for payment and that this fact is reflected in the purchase price. They reason further that to allow the mortgagee also to collect the debt secured by its senior mortgage would result in the unjust enrichment of the mortgagee. . . .

Where, however, the mortgagee purchases at a junior sale and the sum of the two debts exceeds the value of the real estate, this section permits mortgagee to recover on the

⁶⁰ *Id.* § 8.5 cmt. a, at 608.

⁶¹ The *Restatement* goes so far as to refer to an approach that focuses solely on merger as "backward." *Id.* § 8.5, reporter's note at 627.

⁶² *See id.* at 630.

⁶³ *See* *Mid Kan. Fed. Sav. & Loan Assoc. of Wichita v. Dynamic Dev. Corp.*, 804 P.2d 1310 (Ariz. 1991); *Bd. of Trs. of the Gen. Ret. Sys. of Detroit v. Ren-Cen Indoor Tennis & Racquet Club*, 377 N.W.2d 432 (Mich. Ct. App. 1985); *Licursi v. Sweeney*, 594 A.2d 396 (Vt. 1991).

senior obligation to the extent that the value of the real estate is insufficient to fully satisfy those two debts.⁶⁴

Some courts expressly focus on the question of whether the property that the creditor received by foreclosing its junior mortgage exceeded the amount secured by both mortgages, or at least by the one foreclosed.⁶⁵ In each of these cases, the court found that the value of the property exceeded the aggregate amount owed on both loans and denied the lender a judgment on the loan secured by the senior mortgage, which was not foreclosed.⁶⁶ For example, in *Licursi v. Sweeney* the plaintiff foreclosed her third mortgage of \$50,000 and received title to property worth \$240,000 subject to a \$75,000 first mortgage note and the second mortgage note of \$60,000 owned by the plaintiff.⁶⁷ Since the land was thus worth \$55,000 more than the amounts owed on the two notes secured by the remaining two mortgages, the court noted there being no deficiency, the plaintiff could not recover on the note securing her second mortgage. She would have been unjustly enriched if she were allowed to recover on her second mortgage note.⁶⁸

⁶⁴ RESTATEMENT (THIRD) OF PROP.: MORTGAGES, Reporter's Note to § 8.5 at 630.

⁶⁵ See, e.g., *Centennial Square, Ltd. v. Resolution Trust Co.*, 815 P.2d 1002, 1005 (Colo. App. 1991); *Belleville Sav. Bank v. Reis*, 26 N.E. 646, 647 (Ill. 1891); *Tri-County Bank & Trust Co. v. Watts*, 449 N.W.2d 537, 541–43 (Neb. 1989); *Licursi*, 594 A.2d at 396.

⁶⁶ Several of these cases use the term “unjust enrichment” or a close variant. See, e.g., *Tri-County*, 449 N.W. at 539; *Licursi*, 594 A.2d at 399–400. However, the courts never analyzed the elements of a claim of unjust enrichment under the law of the applicable state and concluded that those elements had been satisfied. In *Atlantic Nat'l Trust L.L.C. v. Gunderson*, 132 F. Supp. 2d 1284, 1288–89 (D. Or. 2000), the court did perform such an analysis. The court concluded that to prove a case of unjust enrichment under Oregon law, a party must prove “a benefit conferred, awareness by the recipient that a benefit has been received and, under the circumstances, it would be unjust to allow retention of the benefit without requiring the recipient to pay for it.” *Id.* at 1289 (quoting *Edward D. Jones & Co. v. Mishler*, 983 P.2d 1086, 1101 (Or. Ct. App. 1999)). The court then went on to find that under this standard, the creditor, which had foreclosed its junior mortgage and soon after the foreclosure sale resold the property for an amount approximately equivalent to the total amount secured by both mortgages, was not unjustly enriched. See *id.* at 1289–90. The court did so at least in part on the basis that the two loans had originally been held by separate lenders and the foreclosing creditor (actually a close affiliate of the foreclosing creditor, which the court found was its “alter ego”) had acquired the loan long after it was made. *Id.* An alternative basis stated by the court was that there was no double recovery by the creditor because property sold at a foreclosure sale is simply worth less than that sold in a normal manner. See *id.* at 1289. That conclusion seems questionable at best.

⁶⁷ 594 A.2d 396 (Vt. 1991).

⁶⁸ *Id.*

The *Licursi* court criticized the holding in *Wright v. Anderson* because “it goes beyond familiar principles of unjust enrichment and denies recovery even though the creditor has not obtained the full amount owed from the land.”⁶⁹ The *Licursi* court said that it preferred “a more fact-determinative analysis, based on the equities and the economics of the situation, allowing plaintiff to recover only if the land value were insufficient to cover the debt.”⁷⁰

In *In re Richardson*,⁷¹ the creditor foreclosed its junior mortgage and bought the property at the foreclosure sale for an amount the court found to be the unencumbered value of the property. The creditor later sold the property for a larger amount, but it credited this larger amount to the borrower’s debt before seeking a judgment for the amount remaining unpaid. The court held that because the lender had not tried to take unfair advantage of the borrower, it would be allowed to recover a judgment for the amount of the deficiency.⁷²

In a similar vein, one of the leading treatises on real estate finance states that “where the land is not worth at least the sum of the two debts, to apply the merger doctrine to destroy completely the senior debt shortchanges the mortgagee.”⁷³ It recognizes that allowing the lender to recover a judgment against the borrower for the difference between the value of the property and the amount of the aggregate debt does not result in unjust enrichment.⁷⁴

C. Bidding Presumption

Some courts have taken the view that a lender bidding at the foreclosure sale under its junior mortgage is deemed to have deducted the amount owed on its senior mortgage in deciding how much to bid at the sale; therefore, it should not later be allowed to waive the security for the senior mortgage and recover a judgment on the debt it secured.⁷⁵ The *Wright* court held that, even if the lender appeared not to have taken the senior lien into account in its bid, “she should have done so and unless she can make a showing of

⁶⁹ *Licursi*, 594 A.2d at 399 (criticizing *Wright v. Anderson*, 253 N.W. 484 (S.D. 1934)).

⁷⁰ *Id.*

⁷¹ 48 B.R. 141 (Bankr. E.D. Tenn. 1985).

⁷² *See id.* at 142.

⁷³ NELSON & WHITMAN, *supra* note 5, § 6.16, at 553.

⁷⁴ *Id.*

⁷⁵ *See, e.g., Bd. of Trs. of the Gen. Ret. Sys. of Detroit v. Ren-Cen Indoor Tennis & Racquet Club*, 377 N.W.2d 432, 435–36 (Mich. Ct. App. 1995); *Wright v. Anderson*, 253 N.W. 484, 488 (S.D. 1934).

fraud, excusable mistake, or something of that sort, sufficient to justify vacating the sale, she must be deemed to have done so.”⁷⁶

This theory works reasonably well in some situations. For example, assume that the senior mortgage secures a debt of \$3 million, the junior mortgage secures a debt of \$1 million, and the property is worth \$4 million. If the lender bids \$1 million at the foreclosure sale under the junior mortgage, it receives a property worth an amount equal to the combined amount owed under both mortgages. The bid amount also reflects what a third party bidder—who does not own the senior mortgage—might bid for the property at the foreclosure sale under the junior mortgage.

On the other hand, the value of the property may make it impossible for the bidder to adequately take the senior mortgage into account in bidding at the foreclosure sale under the junior mortgage. For example, suppose the facts are the same as those in the last example except that the value of the property is only \$1 million. The lender thus would receive a property worth only \$1 million, but would be held to have satisfied \$4 million of debt. No third party would bid cash at the sale because it would be buying a property worth less than the senior debt, which would be worthless to a third-party bidder. In such a situation, applying an unjust enrichment theory is fairer to the foreclosing lender. Of course, the lender should anticipate such a situation and—depending on the applicable foreclosure laws of the relevant state—foreclose only the senior mortgage or foreclose both mortgages judicially and seek a deficiency judgment for the aggregate amount not satisfied by the sale.

Ultimately, the bidding-presumption approach appears to be a rough rule of thumb intended to arrive at a result that could be achieved better by a more direct application of an unjust enrichment analysis.

D. Antideficiency Laws

In some cases, courts can find that the antideficiency rules of the relevant state preclude a judgment on the senior debt after foreclosure of the junior mortgage.

In *Board of Trustees of the General Retirement System of Detroit v. Ren-Cen Indoor Tennis & Racquet Club*,⁷⁷ the property was subject to a senior mortgage securing a promissory note with an original principal amount of \$1.1 million, and a junior mortgage held by the same lender securing a note with an original principal amount of \$500,000. The lender

⁷⁶ *Wright*, 253 N.W.2d at 488.

⁷⁷ 377 N.W.2d at 432.

foreclosed the junior mortgage and bought the property at the foreclosure sale for the amount owed on the junior mortgage and then sought a judgment on the note secured by the senior mortgage.⁷⁸ The borrower presented uncontradicted evidence that the property had a fair market value on the date of the sale of more than \$3 million. The court noted that the applicable foreclosure law, which limits deficiency judgments where the amount bid at a foreclosure sale is substantially less than the true value of the property, would have precluded the lender from recovering a deficiency judgment had there been one note and mortgage for the aggregate amount of the debt rather than two.⁷⁹ The court then went on to deny the lender's request for a judgment on the senior debt, applying a somewhat confused merger theory.⁸⁰

California, which has some of the most stringent antideficiency rules, does not have a substantial body of case law on this subject.⁸¹ The absence of California case law may be a result of that state's "security first" doctrine.⁸² The security first doctrine "prevents a secured creditor from ignoring its security and suing on the underlying note or debt."⁸³ Although there do not appear to be any cases on the subject, under the security first doctrine, a California lender is arguably not allowed to foreclose a junior mortgage and

⁷⁸ See *id.* at 433.

⁷⁹ See *id.* at 433–34.

⁸⁰ See *id.* at 436.

⁸¹ Two reported California cases from the state's intermediate appellate courts involved a situation in which a lender with multiple mortgages on a property foreclosed a junior mortgage and later sought tort damages in connection with the loans from a party other than the borrower (in one case the defendant was an escrow company and in the other case it was an appraiser). See *Kolodge v. Boyd*, 105 Cal. Rptr. 2d 749 (Cal. Ct. App. 2001); *Romo v. Stewart Title of California*, 42 Cal. Rptr. 2d 414 (Cal. Ct. App. 1995). While the two cases are inconsistent with one another and are somewhat off the topic of this Article, both invoked merger theory in some fashion in their analysis of the effect of the foreclosure of the junior mortgage. See *Kolodge*, 105 Cal. Rptr. 2d at 758–61, and *Romo* 42 Cal. Rptr. 2d at 420–21. For excellent, detailed discussions of the complexities of California law on the issues explored in this Article, see Michael T. Andrew, *Enforcement Issues for a Creditor Holding Multiple Deeds of Trust on the Same Property*, CAL. REAL PROP. J., 27, no. 1 2009, at 33; and 2 ROGER F. BERNHARDT, CALIFORNIA MORTGAGES, DEEDS OF TRUST, AND FORECLOSURE LITIGATION §§ 9.26–.31 (4th ed. 2009).

⁸² California's security first doctrine is derived from CAL. CIV. PROC. CODE § 726(a) (West 1976 & Supp. 2009).

⁸³ 1 ROGER F. BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 4.6 (4th ed. 2009).

later seek a judgment on the debt secured by the senior mortgage without foreclosing the senior mortgage.⁸⁴

IV. EFFECT OF FORECLOSURE OF JUNIOR MORTGAGE ON LIEN OF SENIOR MORTGAGE

Occasionally, a third party bidder has purchased a property at the foreclosure sale under a lender's junior mortgage, and then has challenged the lender's later foreclosure of its senior mortgage on theories similar to those described above. Such challenges have not been successful.

In *Mann v. Household Finance Corp. III*,⁸⁵ the third party bidders bought a house at the nonjudicial foreclosure sale on the lender's junior mortgage. About a month after the sale, the lender began foreclosure proceedings on its senior mortgage. The buyers did not attempt to enjoin the sale under the senior mortgage, and the lender bought the property at that sale. Later, the third party buyers sued to quiet title or to rescind their purchase. The court, quoting a local law treatise, held that "a nonjudicial foreclosure eliminates all subordinate liens and other interests in the property but has no effect on liens and other interests that are prior to the deed of trust."⁸⁶ The buyer does not appear to have argued a merger theory.

*Ostayan v. Serrano Reconveyance Co.*⁸⁷ presented a situation factually very similar to that in *Mann* except that the third party buyer did make some species of merger argument. The court held that the lender's senior mortgage did not merge upon completion of the foreclosure sale under the junior mortgage at which the buyer was the successful bidder, and the court allowed the lender to complete its later foreclosure of the senior mortgage.⁸⁸ The court distinguished *Simon v. Superior Court* and *Union Bank v. Wendland*,⁸⁹ stating:

In this case, we do not have a creditor seeking to avoid the reach of the antideficiency legislation. [The lender] simply foreclosed on its junior lien with full disclosure to all. No deficiency judgment was sought, nor does such a

⁸⁴ See *id.*

⁸⁵ 35 P.3d 1186 (Wash. Ct. App. 2001).

⁸⁶ *Id.* at 1188.

⁸⁷ 92 Cal. Rptr. 2d 577 (Cal. Ct. App. 2000).

⁸⁸ See *id.* at 577.

⁸⁹ See *Simon v. Superior Court*, 5 Cal. Rptr. 2d 428 (Cal. Ct. App. 1992); *Union Bank v. Wendland*, 126 Cal. Rptr. 549 (Cal. Ct. App. 1976). For a discussion of these cases, see *supra* Part II.

result effectively flow. The successful bidder, Ostayan, had every right, as purchaser, to assume the senior lien and go forward as owner of the property. Had Ostayan not made a legal error and made an excessive bid he would have had every economic incentive to step into the [original borrower's] shoes and protect his interests by assuming the [senior mortgage] obligation.⁹⁰

These cases indicate that although courts sometimes use merger theory to protect a borrower from a judgment on the senior debt, they are reluctant to use merger theory to protect a third party buyer at a foreclosure sale from subsequent foreclosure of the senior mortgage.⁹¹ Of course, in such situations, if the junior mortgage is cross-collateralized so that it also secures the debt secured by the senior mortgage, depending on the facts and the specific provisions of the antideficiency laws of the applicable state, foreclosure of the junior mortgage *may* operate to preclude a later foreclosure of the senior mortgage.

V. DEEDS IN LIEU OF FORECLOSURE

After default, the borrower may offer to provide the lender with a deed in lieu of foreclosure, by which it transfers the property to the lender in full or partial satisfaction of the debt. If the lender accepts a deed in lieu of foreclosure of one or both mortgages, it needs to address the issue of its right, if any, to be paid an amount in addition to obtaining title to the property. That issue must be dealt with clearly in the deed in lieu of foreclosure agreement; however, the reported cases show that lenders and borrowers sometimes fail to address it properly. In such cases, some courts have approached the issue of the survival of the obligations secured by the property as a question of merger.⁹² In addition, some states have statutes providing that the giving of a deed in lieu of foreclosure satisfies the debts to the grantee secured by the property in the absence of an agreement to the contrary.⁹³

⁹⁰ *Ostayan*, 92 Cal. Rptr. at 586.

⁹¹ *See, e.g.*, WASH. REV. CODE ANN. § 61.24.100 (West 2009).

⁹² *See, e.g.*, *Van Woerden v. Union Improvement Co.*, 287 P. 870, 872 (Wash. 1930).

⁹³ *See, e.g.*, 735 ILL. COMP. STAT. ANN. 5/15-1401 (West 1993); WASH. REV. CODE ANN. § 61.24.100(7) (West 2009). The Illinois statute expressly requires such agreement take the form of "an instrument executed contemporaneously," but the Washington statute does not. The Illinois statute also expressly provides that a deed in lieu of foreclosure does not effect a merger.

VI. STRATEGIES FOR THE LENDER

The current state of the law on the issues discussed in this Article is confusing, inconsistent, and often unpredictable. However, there are strategies the lender can use to minimize the risks.

A. Structuring and Documentation Strategies

1. *Strategies*

At the time the loans are made, the lender and its lawyers should consider methods of structuring and documenting the transaction to minimize the risks described in this Article. Some methods to consider include:

a. *Make Additional Advance on Senior Loan*

The lender can make a single loan secured by one mortgage rather than making two loans secured by two mortgages. If the lender has already made the first loan, the lender can make the second loan as an additional advance under the first loan and modify the existing loan documents to increase the principal amount. Of course, this strategy becomes problematic if there are junior liens on the property held by third parties.

b. *Avoid Structures That Appear to Evade Antideficiency Laws*

The lender should be careful to avoid any structure that could be construed as an attempt to circumvent applicable antideficiency laws. If two loans secured by the same property are made at about the same time by the same lender, they are more likely to be susceptible to an argument that they were designed to evade antideficiency laws, especially in states such as California, Georgia, and Oregon, whose laws are highly sensitive to such structures.⁹⁴ Even if the loans are held by separate entities under common control, the court may find that the separate entities are alter-egos of one another and that they should be treated as a single entity.⁹⁵

c. *Include Anti-Merger Provision*

The lender should include a provision in each of the mortgages declaring that the parties specifically intend that the two mortgages will not merge and that the debts they secure will not be extinguished as a result of the lender acquiring title to the property through a foreclosure, a deed in lieu of foreclosure, or otherwise. Although courts may not necessarily give effect

⁹⁴ See, e.g., *Alliance Mortgage Co. v. Rothwell*, 900 P.2d 601, 606 (Cal. 1995).

⁹⁵ See, e.g., *Equitable Sav. & Loan Ass'n v. Lenz*, 436 N.W.2d 902, 904 (Wis. Ct. App. 1989).

to such a provision—especially when it would operate to unjustly enrich the lender—the inclusion of such a clause does help to establish the parties’ intent.

d. Avoid Inappropriate Cross-Collateralization

The lender should carefully consider what debts should be secured by each mortgage. Applicable antideficiency statutes may provide that foreclosure of a mortgage satisfies personal liability for the debts secured by that mortgage, either as to the borrower⁹⁶ or as to the borrower and guarantors.⁹⁷

2. *Summary*

When documenting a financing arrangement, simplicity is often the best approach. Where all the debt owed to the lender is secured by a single mortgage, none of the dangers discussed in this Article will arise. Where the lender does have multiple mortgages, it should be careful at the documentation stage to include appropriate anti-merger language in the mortgages and to consider how the foreclosure process would play out in the relevant state and structure the mortgages accordingly.

B. Foreclosure Strategies

1. *In General*

The lender’s lawyer often will not have an opportunity to structure the loans and will be presented with two loans that already have been structured and documented without attention to the issues discussed in this Article. In that situation, the lawyer will have to prepare a strategy to best protect the lender’s interests in light of the situation as it exists at the time of default. In such cases, the appropriate strategy will be driven by the amounts secured by the two mortgages, the value of the property, the antideficiency, and one-action rules of the relevant state, whether two loans are cross-collateralized, and whether either mortgage covers property in addition to that covered by the other mortgage.

2. *Strategies*

The lender and its lawyer should consider, among other things, which of the following three foreclosure approaches it should pursue.⁹⁸

⁹⁶ See, e.g., WASH. REV. CODE ANN. § 61.24.100 (West 2009).

⁹⁷ See, e.g., OR. REV. STAT. § 86.770(2) (2007).

⁹⁸ This Article considers only state law foreclosure strategies and does not discuss other possible strategies, such as encouraging the borrower to sell the property in a voluntary sale and applying the proceeds to the debt or forcing the borrower into bankruptcy with the intent

a. *Foreclose Junior Mortgage First*

The lender can foreclose the junior mortgage and bid an amount at the sale that reflects the amount the lender would have bid if the senior mortgage were owned by a third party.⁹⁹ At the same time, the lender can schedule a foreclosure sale on the senior mortgage to take place immediately following the sale on the junior mortgage.

With this approach, if the lender buys at the sale under the junior mortgage, it does so at a price that assumes it will not be able to obtain a judgment on the note secured by the senior mortgage, and it can recover a deficiency judgment on the junior mortgage if appropriate.¹⁰⁰ However, this strategy depends on the property having a value in excess of the amount owed on the senior mortgage.¹⁰¹

For example, a lender may hold a senior mortgage securing a \$1 million debt and a junior mortgage securing a \$3 million debt on a property with a value of \$3 million at the time of foreclosure. In this example, the lender would bid approximately \$2 million at the foreclosure sale on the junior mortgage—about what a third party bidder would pay for a \$3 million property subject to \$1 million in secured debt. Because that bid would leave \$1 million unpaid on the junior debt, the lender could proceed to obtain a deficiency judgment on the junior debt and treat the senior debt as extinguished.

b. *Foreclose the Senior Mortgage*

Of course, the preceding strategy would not work if the amount secured by the senior mortgage is equal to or exceeds the value of the property. In that situation, if the lender has a borrower or guarantor with substantial assets, the lender will likely want to foreclose the senior mortgage and wipe out the junior mortgage, but retain the ability to seek a judgment on the junior debt and, if appropriate, seek a deficiency judgment on the senior debt. That strategy, however, would not work in California under the rule of *Simon v. Superior Court*,¹⁰² discussed in Part II.B.

to have the property sold in a bankruptcy court-approved sale. Those strategies can have advantages to the lender, such as saving time and litigation costs and, in an appropriate case, avoiding state transfer taxes if the sale is accomplished pursuant to a confirmed plan in a Chapter 11 bankruptcy case. *See* 11 U.S.C. § 1146(a) (2006); *see also* Fla. Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326 (2008).

⁹⁹ *See, e.g.*, *Tri-County Bank & Trust Co. v. Watts*, 449 N.W.2d 537, 542 (Neb. 1989).

¹⁰⁰ *See, e.g.*, *Burkhart*, *supra* note 55, at 333.

¹⁰¹ *See Tri-County*, 449 N.W.2d at 543.

¹⁰² Cal. Rptr. 2d 428 (Cal. Ct. App. 1992).

c. Foreclose Judicially and Seek a Deficiency Judgment

A third strategy would be to commence a judicial foreclosure action on both mortgages, and have the court approve the precise order of the foreclosure sales and the means for entering any appropriate deficiency judgment. In some cases, this approach may be the only practical one. Such cases would include when the applicable state does not have a nonjudicial foreclosure remedy or if its antideficiency law prohibits a deficiency judgment against the borrower after a nonjudicial foreclosure, the borrower has significant assets outside the property, and the property is worth substantially less than the amount of the senior secured debt.

If only the junior mortgage is in default and there is no cross-default clause in the senior mortgage—which would cause it to be in default as a result of the default on the junior mortgage—the lender may want to judicially foreclose the junior mortgage and ask the court to provide in the decree of foreclosure that the foreclosure of the junior mortgage will not cause the merger or extinguishment of the senior mortgage.

This approach has a variety of probable disadvantages. For example, a judicial foreclosure can be time consuming and expensive, and it may encourage the borrower or guarantors to assert defenses they might not assert in a nonjudicial foreclosure simply because it is easy to file an answer asserting such defenses in a judicial foreclosure—in a nonjudicial foreclosure, the borrower or guarantor would have to file an independent action seeking to restrain the foreclosure sale. Of course, many states do not have a nonjudicial foreclosure remedy and a judicial foreclosure is always necessary.

3. Summary

At the foreclosure stage, the lender must use heightened care in analyzing the applicable law and be certain to foreclose in a manner that will not inadvertently extinguish any mortgage or debt that the lender needs to preserve. In some cases, the law may be so unclear that the prudent course is to judicially foreclose and ask the court to provide in the decree of foreclosure how the foreclosure sale or sales will be conducted and what the effect of the first foreclosure sale will be on the remaining mortgage.

VII. CONCLUSION

The lender holding two mortgages on the same property is faced with several important issues, which have the potential to disrupt the foreclosure process and to disappoint the expectations of the lender if they are not addressed appropriately. The appropriate resolution of these issues is highly dependent on the specific facts of the situation and on the law of the rele-

vant state, especially any applicable antideficiency rules. A strategy that is appropriate in one state could be disastrous for the lender in another state; therefore the lender's counsel must carefully analyze the law of the applicable state.

Although the law applicable to these types of loans is somewhat complex and uncertain, with appropriate planning, lenders and their lawyers should be able to navigate these uncertainties to achieve an acceptable result.

As a policy matter, courts can reach fairer and more consistent results by focusing on whether the lender is being unjustly enriched by the foreclosure strategy it has employed, rather than by employing arcane doctrines to cases where they do not properly apply.

